Internal Revenue Service
memorandum

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Br2:WDHussey

date: APR 25 1988

to: District Counsel, Oklahoma City CC:SW:OKL
Attn: CGMcLoughlin

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This responds to your request for technical advice of March 30, 1988.

ISSUE

Whether a taxpayer may recognize a loss on the open market sale of participation certificates in mortgage pools issued by [redacted], [redacted], or similar organizations, when the proceeds are soon reinvested by the open market purchase of similar mortgage pool certificates with substantially different interest rates.

RECOMMENDATION

We agree with your proposal to advise the District Director against issuing a notice of deficiency.

FACTS

[redacted] and its subsidiaries acquired participation certificates in mortgage pools of the [redacted] ([redacted]), [redacted] ([redacted]), and similar organizations by exchanging mortgages held in their portfolios for the certificates. The taxpayers reported no gain or loss on these exchanges.

The taxpayers then sold the certificates on the open market for cash. The taxpayers treated these sales as taxable transactions. Since the portfolio mortgages had been low interest, fixed rate mortgages, rising interest rates had driven their fair market values below their principal balances. The taxpayers claimed losses with respect to the differences between their bases in the mortgages and the sales proceeds from the certificates. These losses resulted in net operating loss carrybacks.

The taxpayers very soon afterwards replaced the mortgage pool participation certificates thus sold by purchasing other mortgage pool participation certificates from [redacted], [redacted], and similar organizations. The new certificates were in pools of mortgages with significantly higher fixed interest rates, or with variable rates. Many of these mortgages were insured by the [redacted] or [redacted], whereas the mortgages formally held by the taxpayers had been conventional. In response to our telephone inquiry, you have learned from the Examination Division, [redacted] District, that neither the mortgages exchanged by the taxpayers nor the mortgages represented by the new mortgage pool certificates had prepayment penalties. You have also informed us telephonically that the remaining terms to maturity of the pooled mortgages given up were about [redacted] years and the remaining terms of the pooled mortgages acquired were over [redacted] years. These transactions occurred during the fiscal years ended [redacted], through [redacted], the fiscal years ended [redacted], through [redacted], the fiscal year ended [redacted], and the fiscal years ended [redacted], through [redacted].

Examinations Division has asked you whether the claimed losses may be disallowed on the ground that the participation certificates sold did not differ materially from those purchased, based on the "mass asset" approach of Rev. Rul. 81-204, 1981-2 C.B. 157.

DISCUSSION

The mortgage swap described in Rev. Rul. 81-204, 1981-2 C.B. 157, considered in G.C.M. 38838, [redacted], I-49-81 (April 19, 1982), concerned literal swaps of mortgage pools by three savings and loans associations in the same locality. The ruling concluded that the pools were "mass, indivisible assets that averaged out the unique characteristics and risks inherent in each constituent mortgage." Since the mortgages had the same interest rates and terms to maturity, the ruling held that the exchanged pools did not differ materially in kind or extent within the meaning of Treas. Reg. § 1.1001(a), precluding realization of gain or loss under section 1001(a). The ruling further held that the exchange was a sham with no significant economic or business purpose, precluding deduction of a loss under section 165(a). Literal swap transactions of the type addressed by Rev. Rul. 81-204 are known as "first generation" mortgage swaps.

Rev. Rul. 85-125, 1985-2 C.B. 180, considered in G.C.M. 39149, [redacted], I-166-82 (March 1, 1984), addressed "second generation" swaps. Three unrelated savings and loan associations entered into concurrent transactions in which each "sold" and "purchased" mortgage pools on a round-robin basis. It was hoped that the receipt of cash would prevent the Service from characterizing the transactions as "exchanges." Rev. Rul. 85-125 collapsed the purported purchases and sales into exchanges and denied the claimed losses.

G.C.M. 39551, [redacted], I-087-84 (June 30, 1986), considered a "third generation" swap in which a savings and loan association sold [redacted] participation certificates to a broker at a loss and almost immediately thereafter purchased substantially identical [redacted] participation certificates. There was no obligation to purchase substantially identical certificates and no indication that the savings and loan association knew who would purchase its certificates. G.C.M. 39551 concluded that the wash-sale rules of section 1091 applied to preclude recognition of any loss realized from the sale.

The Service is examining its position with regard to "fourth generation" cases. These are cases in which mortgage pools or participation certificates given up differ from those acquired with respect to one or more of the ten identity criteria established in [redacted] Memorandum Rule 49. If these criteria are satisfied, mortgage pools are considered substantially similar for regulatory purposes and produce no loss for regulatory purposes. The Service has considered the degree of identity achieved by these criteria a basis for concluding that there was no material difference in kind or extent between mortgage pools given up and those acquired in transactions conforming to the R-49 criteria. The ten criteria are that the mortgage pools:

1. Be single family residential mortgages;

2. Be of similar type (i.e., conventional for conventional);

3. Have same stated term to maturity;

4. Have same stated interest rate;

5. Have same seasoning (i.e., remaining term to maturity);

6. Have aggregate principal amounts within the lesser of 2 1/2% or $100,000 (plus or minus) on both sides of the transaction;

7. Be sold without recourse;

8. Have similar fair market values;

9. Have similar loan-to-value ratios at the time of reciprocal sale;

10. Have all properties in the same state.

We are currently unable to provide you with definite criteria for determining when loan swap losses should be realized or recognized for tax purposes. Nevertheless, we conclude that the mortgage participation certificates sold by the instant taxpayers were substantially different from those purchased in replacement because of the following characteristics:

1. The mortgage pools sold and acquired contained mortgages of different type, as conventional loans were given up for [redacted] and [redacted].

2. The stated remaining terms to maturity were different. The participations sold were in mortgage pools with approximately [redacted] years remaining. The participations acquired were in pools with over [redacted] years remaining.

3. The pools sold and acquired contained mortgages with materially different stated interest rates, or replaced fixed mortgages with variable rate mortgages.

4. The replacement of a portion of the pools containing fixed rate mortgages with pools containing variable rate mortgages ensures that materially different economic yields will result, at least over the long haul.

The last two factors are especially significant. As there are no prepayment penalties, it is likely that the higher stated interest rate loans acquired will be paid off before the lower stated rate loans given up for them. There is a countervailing likelihood that those of the lower stated interest loans given up for variable rate loans will be paid before the variable rate loans. However, the latter tendency will not be as significant as the former, as market interest rates will have to fall further to make payoff of the lower stated interest rate loans attractive than they will have to fall in order to precipitate payoff of the higher stated interest rate loans. By acquiring participations in mortgage pools with higher stated interest rates, the taxpayers have exposed themselves to a greater likelihood of prepayment than they had with respect to the participations given up. They are thus more likely to lose the benefit of interest rates which they had otherwise locked in than if they had retained their original portfolios. Lower stated interest rates would have served to lock in relatively favorable yields by discouraging mortgagors from prepaying their loans.

In conclusion, the participation interests sold by the instant taxpayers were substantially different from the participation interests acquired for purposes of section 1001 and 1091. The taxpayers may recognize their claimed losses.

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